Exhibit A

STATEMENT ON FCC DEPRECIATION REQUIREMENTS

NOTICE OF PROPOSED RULEMAKING

CC DOCKET NO. 98-137

BY DR. ROBERT G. HARRIS

LECG
ECONOMICS • FINANCE

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BIOGRAPHY OF ROBERT G. HARRIS

Dr. Robert G. Harris is Professor Emeritus of Business and Public Policy in the Haas School of Business, University of California, Berkeley, and a Principal in the Law & Economics Consulting Group. He earned B.A. and M.A. degrees in Social Science from Michigan State University, and M.A. and Ph.D. degrees in Economics from Berkeley.

Dr. Harris has published more than 50 articles analyzing the effects of economic regulation and antitrust policy on industry performance and the implication of changing economics, market conditions and technology for transportation and telecommunications policies. He has consulted to the U.S. Department of Transportation, the U.S. General Accounting Office, the U.S. Office of Technology Assessment, the U.S. Department of Justice, the California Attorney General and the California Department of Consumer Affairs. He has advised the Economic Planning Agency of Japan on major structural reforms of Japanese regulatory policies in telecommunications, transportation and electric power. In 1980-81, he served as a Deputy Director of Cost, Economic & Financial Analysis at the Interstate Commerce Commission, where he was responsible for major changes in depreciation policies related to the implementation of motor carrier and railroad deregulation.

Dr. Harris has testified before Congressional committees on antitrust, regulatory policy and telecommunications legislation and before the Federal Communications Commission and the state regulatory commissions of Arizona, California, Colorado, District of Columbia, Florida, Illinois, Idaho, Indiana, Iowa, Kansas, Michigan, Minnesota, Montana, Nebraska, Nevada, New Mexico, North Dakota, Ohio, Oregon, Pennsylvania,

South Dakota, Tennessee, Utah, Virginia, Washington, West Virginia, and Wisconsin on telecommunications policy, telephone rate design and incentive regulation. He has served on the California Task Force on Telecommunications Network Infrastructure and on an International Advisory Committee to the Economic Planning Agency of Japan.

Professor Harris has consulted to the U.S. Department of Transportation, the U.S. and California Departments of Justice and leading telecommunications, transportation and energy companies, including IBM, SUN Microsystems, Ascend Communications, NORTEL, Pacific Bell, General Telephone, US West, Ameritech, Bell Atlantic, Bell Communications Research, BellSouth, Southwestern Bell, SNET, NYNEX, Primeco PCS, Consolidated Freightways, Southern Pacific, American Presidents' Lines and Pacific Gas & Electric.

I. Introduction/Organization

A. Executive Summary

Beyond changes driven by new state and federal policies, the recent rate of technological change and competitive entry in local telecommunications markets has been staggering. The wide array of technologies and services that have a competitive impact on traditional providers of telephone service highlight the importance of market-oriented flexible regulation. The purpose of this statement is to comment on behalf of SBC Communications Inc. on the FCC's July 22, 1998 Notice of Proposed Rulemaking (NPRM) on the Commission's depreciation prescription process.[1]

Given this backdrop, the FCC should recognize its obligation to respond to changes in the market and in the competitive structure of the telecommunications industry. The era for depreciation prescription has passed. The costs in terms of time and money of depreciation prescription regulation are an unnecessary burden to both the FCC and the ILECs. Changes in Federal price cap rules are acting as a watchdog over firms' profits, thereby rendering depreciation prescription useless. Furthermore, the increasingly competitive environment is constraining depreciation practices. Traditional telephony is being challenged by new technologies that offer alternative means of communications and that are changing market incentives. The rapid pace of technological change indicates that it is has not only become extremely difficult to accurately prescribe

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[1] Notice of Proposed Rulemaking, *In the Matter of 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket No. 98-137, FCC 98-170, October 14, 1998. ("NPRM")

depreciation lives, but also that the prescription of depreciation lives itself should be eliminated completely and ILECs must be allowed to set their own truly forward looking depreciation lives.

B. Definition of Economic Depreciation

The economic depreciation of an asset over a given time period is considered the change in the value[2] of the asset during that year, typically a reduction. Depreciation is caused by a number of factors:

- the physical deterioration of the asset, which leads to lower quantity or lower quality of output,
- increased maintenance costs,
- the introduction or expectation of less expensive or higher quality substitutes or substitutes which can generate new revenue streams due to increased functionality,
- an actual or expected decrease in demand for the product produced by the asset.

Investment decisions to replace still physically functioning plant are thus typically driven by economic analysis showing that the new plant placement would improve operational results or customer service quality. A key aspect of economic depreciation, which the FCC itself recognizes, is that it should be based on a *forward looking* analysis of the factors listed above.[3] In this sense, depreciation is only an estimate or best guess about

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[2] Value should be defined with respect to an asset's usefulness in providing or supporting the services demanded by the company's customers, and its ability to generate future cash sufficient to recover the asset.

[3] NPRM, p. 3.

future economic conditions. Thus, to be accurate, particularly during times of rapid technological or market changes, forward looking depreciation lives must be updated as new information comes to light. Forward looking depreciation rates should be used in regulatory contexts to ensure that regulatory policies are based on more efficient economic principles.

II. Changes in Federal Price Cap Rules Eliminate the Need for Prescription

A. Price Caps Curtail the Need for Additional Protection Against Supracompetitive Profits

Historically, depreciation rates were prescribed for rate-of-return regulated companies to ensure that the companies recovered the cost of investments in plant over their useful life. This guaranteed that companies with market power, such as incumbent local exchange carriers (ILECs), did not "over recover" the costs of their investments from local telephone subscribers.[4] Thus, under rate-of-return regulation, there was a direct link between depreciation rates and the prices paid by consumers for local exchange services. More recently, price cap regulation has replaced the inefficient rate-of-return system.

Price cap regulation has been implemented for large ILECs' federally tariffed services and sharing provisions have been removed. As such there is no longer a direct link between revenue requirement, costs, and prices. Therefore, there is no reason for price cap companies to be required to use prescribed depreciation lives or even prescribed

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[4] Depreciation rates were restrained by regulators to keep customer rates low in the short term by extending the period over which investment expenses were recovered. This extension of prescribed lives beyond economic lives was workable as long as there was little competition impacting local exchange companies.

depreciation ranges. If price cap companies tried to increase their depreciation rates above economic levels, there would be no impact on customer prices since the price cap and associated calculations are predicated on adjusting a revenue base by movements in inflation and productivity. Since depreciation ranges are no longer salient to price regulation, they should be removed.

B. *The FCC Can Review Depreciation Practices If an Application for A Low-End Adjustments is Filed*

A rule exists which could allow price cap companies to adjust access rates upwards when their returns fall below 10.25 percent.[5] It is my understanding that low-end adjustments have very seldom occurred in the past. Thus, it would be irrational to set prescribed depreciation life ranges, require carriers to develop extensive justifications of their depreciation rates, and apply for permission to use depreciation lives outside predetermined ranges based on these remote occurrences. Instead, the Commission should review the depreciation lives on a case by case basis only in situations when carriers file tariffs predicated on the low-end adjustment, saving the remaining price cap companies and the Commission the extensive effort of preparing and reviewing the associated support studies.

C. *The Prescription Process Imposes an Unnecessary Burden on LECs and FCC*

Although the FCC has streamlined the documents it requires ILECs to file in the depreciation prescription process, these limited filings still place a substantial reporting burden on both the ILECs and the Commission staff responsible for processing,

analyzing and approving these documents. Also, as the Comments of SBC in this proceeding indicate, the proposal to reduce the depreciation filing to include only summary exhibits does not materially affect the filing costs since extensive underlying studies and documentation still need to be prepared in support of the summary filings. As a recent report by Arthur Andersen highlights, the complicated regulatory ILEC reporting requirements associated with depreciation accounting are no longer necessary.

> Such depreciation practices are no longer practical in the current price cap regulatory environment, where prices of services are regulated as opposed to the costs incurred to provide such services. The LECs should be relieved from the costs associated with the depreciation represcription process and should be allowed to implement depreciation practices and methods consistent with "best practice" companies under GAAP.[6]

A separate report by Arthur Andersen states that on average, ILECs included in the report would save $400 thousand per year if depreciation expense practices were simplified.[7] As I explain in other portions of this statement, these costs imposed on both the Commission staff and the ILECs are not counterbalanced by any substantial benefits.

III. Increased Competition Reduces the Need for Prescription

A. The Implications of Depreciation Practices in a Competitive Market

In a competitive market, depreciation (as reflected on firms' financial statements) is based on their expectations of the useful lives of investments in plant and equipment. For

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[5] CFR, Part 61.45 (d) (1) (vii).

[6] *In the Matter of 1998 Biennial Regulatory Review – Review of Accounting and Cost Allocation Requirements*, CC Docket No. 98-81: *Accounting Simplification in the Telecommunications Industry*, Arthur Andersen LLP, July 15, 1998, p. 30.

[7] *Supplement to Accounting Simplification in the Telecommunications Industry, July 15, 1998*, Arthur Andersen LLP, November 10, 1998, p. 8.

example, when General Motors invests in building a new automobile plant, they project the working life of the plant and set their depreciation rates accordingly. If the company tried to recover their investment costs more quickly than is economically justified, by increasing depreciation rates above economic levels and marking up the prices of their cars, their competitors (e.g. Ford and Toyota) are likely to gain sales, market share and profits at GM's expense by pricing their cars at lower levels that more accurately reflect current economic depreciation lives for auto plants. Thus, in competitive industries, market forces alone constrain firms' depreciation decisions.[8]

In the NPRM, the FCC recognizes that competitive forces will ultimately constrain LECs' depreciation practices and will allow for the elimination of depreciation prescription. The Commission acknowledges that:

> As soon as robust competition exists in the local exchange markets, we believe our depreciation process should be eliminated because it will be unnecessary. In a robustly competitive market, both the incumbent LECs and their competitors should charge prices that are at or near their costs, including depreciation, in order to attract customers and maximize their profits. In such a market a carrier's ability to raise its depreciation rates would be constrained by its need to compete against other carriers, rather than by government regulatory constraints.[9]

As I will elaborate later, LECs are in fact already facing an increasingly competitive market.

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[8] Obviously accounting and tax rules also constrain depreciation decisions of firms in competitive markets.

[9] NPRM, p. 7.

B. Local Exchange Competition is Greater than the FCC Recognizes

The NPRM argues that the market is not yet competitive enough to remove the need for regulatory constraint of LECs depreciation practices.[10] The FCC bases this assessment of competition in local exchange markets on nationwide market share data which shows incumbent LECs' share of local exchange revenues compared to CLECs and CAPs.[11]

There are a number of flaws in the FCC's analysis of competition in the local market cited here. First, the market share figures cited are backward looking since they are based on 1996 data. Although the FCC projects that non-ILEC market share could triple to 3 percent in 1997,[12] it does not make an estimation for 1998 which will be even higher.

1. CLECs Are Successfully Entering Key Local Exchange Market Segments

Following the passage of the Telecommunications Act of 1996, a large number of CLECs successfully entered local exchange markets to compete for business customers in higher density urban areas. There were 1,429 CLECs as of July 1998 holding 2,844 competitive local exchange certificates issued by state regulators.[13] According to a recent financial analyst report, CLECs as a group added more business access lines than

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[10] "Unfortunately, the local exchange market today is not such a market," NPRM, p. 7.

[11] The FCC defines local revenues "to include revenues from local exchange, local private line, and other local services, as well as from interstate and intrastate access services but not to include revenues from cellular or other mobile services or from toll (i.e. long distance services)." (See "Trends in Telephone Service," Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, July 1998, Table 8.1 notes.)

[12] NPRM, Footnote 33, p. 6.

[13] See "Number of CLECs in U.S. Now Exceeds Total Incumbent Telcos," *State Regulation Report*, September 18, 1998, p. 1.

RBOCs did in the first quarter of 1998.[14] SBC recently noted that it has lost more than 1 million access lines to CLECs.[15] The CLECs are building their own facilities and leasing the unbundled network elements and reselling the services of ILECs.

Some local exchange market segments such as the high capacity transport and large line size business customer markets in most large urban areas around the country have become quite competitive and no longer merit regulation to constrain pricing.

Another critical flaw in the FCC's market share data that I will discuss below is that it does not include intermodal[16] or indirect forms of competition (such as wireless, PBX and cable) which compete with wireline local exchange service in a number of market segments.

2. Wireless Service is Competing with Wireline

Wireless services[17] are increasingly competing with wireline local exchange services since they are becoming a substitute for some landline services. Many calls that would

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[14] J.V Grubman, "CLECs Surpass Bells in net Business Line Additions for the First Time," *Salomon Smith Barney*, May 6, 1998.

[15] Ex Parte Letter from Todd F. Silbergeld, CC Docket No. 97-121, September 1, 1998.

[16] The term "intermodal" was traditionally used in the surface freight transportation industry to describe competition between railroads, long haul trucking and river barge shipping. I use it here to connote the difference between traditional wireline local exchange competition and other forms of competition such as wireless, VSAT and microwave carriers.

[17] For my purposes, wireless services are defined as traditional analog and digital cellular services, personal communications services (PCS), and enhanced SMR (Special Mobile Radio) services. SMR is provided by companies such as NexTel.

have otherwise been made on landlines are now placed using wireless facilities. Some customers are actually canceling their wireline service (and others are simply not expanding to second lines) because they are substituting wireless for wireline services.[18] Competitors, such as AT&T and Sprint are already actively marketing their wireless services as *local loop replacements*.[19] AT&T's marketing of its "Digital One Rate Plan" even stated that it "could make your wireless phone your only phone."[20] Its latest promotion of a "Wireless Home Phone Option" in Plano, TX even offers unlimited airtime within the fixed local calling area.[21] These wireless calling plans replace the need for many second local exchange lines and even some primary local exchange lines. The FCC acknowledged this in its latest CMRS Competition Report:

> In addition to competing with each other for shares of the mobile telephone market, cellular, broadband PCS, and digital SMR operators can also potentially provide competition with wireline providers in the market for local exchange service.[22]

Other wireless strategies, such as AT&T's "Project Angel," are attempting to enter the local exchange market by using PCS spectrum and wireless local loop technology.[23]

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[18] See Roy Furchgott, "Cutting the Phone Cord," *New York Times*, September 17, 1998.

[19] "Sprint PCS Reaches One Million Customers," *Sprint News Release*, February 3, 1998; "PCS vs. Cellular Pricing; This is war; PCS Competitive Markets: Pricing Strategies," *Paul Kagan News, Wireless Market Stats. #96*, August 25, 1997; and "Survey Shows GSM Phones Can Sub for Wired Phone Lines," *Newsbytes*, July 6, 1998.

[20] AT&T Digital One Rate, *AT&T Wireless Services Web Site.* <www.attws.com>

[21] "Wireless offered for secondary home lines in Plano," Dallas Morning News, November 12, 1998 and "AT&T Wireless Home Phone Option," *AT&T Promotional Materials*, September 1998.

[22] "Third Annual CMRS Competition Report," Federal Communications Commission, FCC 98-91, June 11, 1998, p.26.

[23] According to press accounts, AT&T plans to test its system in several thousand homes next year and to role it out commercially by the year 2000. If successful, this could significantly affect the market for local

3. *PBX, Satellite and Microwave are Expanding Competition*

Private branch exchanges (PBXs) and internal corporate networks have been competing directly for business customers' local exchange services for many years. PBXs supply their own switching and enhanced services for intra-company calls. Many large businesses have private networks that do not use the public-switched telephone network for intra-company calls, thereby substituting the need for local exchange services. PBXs also reduce the need for access lines because they aggregate calls of multiple users over shared lines.

Satellite and microwave services, such as very small aperture satellites (VSATs), also compete effectively with local exchange lines. VSATs are used widely in regional and nationwide corporate private telecommunications networks for communications such as data, voice and fax and are commonly used for dial up credit card transactions and reservation processing centers.[24] The cost efficiency of VSATs, their ease of installation, and the benefits of maintaining a secure internal corporate network makes them an extremely attractive alternative to local exchange service.

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exchange lines. (See Peter Elstrom, Catherine Arnst, and Roger Crockett, "At Last, Telecom Unbound," *Business Week*, July 6, 1998: 26.)

[24] VSATs are also commonly used in the wholesale and retail oil industry, grocery and other retail store chains, government, banking and financial services, car dealerships, drug stores, electric utilities and hotel reservation systems.

4. The Growth of the Internet has made Cable a Serious Competitor

The widespread adoption and increasing commercial importance of the Internet is likely to have powerful, and hard to predict, implications for local exchange companies' depreciation rates. On the one hand, today's customers are increasingly demanding multiple residential telephone lines for their growing Internet uses. Incumbent LECs are also rolling out xDSL (digital subscriber line) technologies on their local exchange networks which they hope will extend the economic lives of a large portion of their existing plant by providing high speed data connections to the Internet. However, other countervailing technologies may compete aggressively with xDSL. For example, the cable-modems mentioned earlier being deployed by companies like AT&T/TCI, Time Warner, Cox and others offer substantially higher speed transmission rates than xDSL technologies. Additionally, satellite and other wireless connections to the Internet such as Direct PC may increasingly leave local telephone companies technologies outmoded. I would point out that the competitive significance of cable modems has only recently become apparent. In as little as five years, they have become an important competitive factor in the telecommunications environment.

It is estimated that the number of cable modem subscribers in North America surpassed 250,000 as of July, 1998.[25] Cable modems provide an attractive alternative for both second analog lines used for connecting to dialup ISP service, and for xDSL service for

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[25] "Cable Modem Market Stats and Projections," *Cable Datacom News*, <www.cabledatacomnews.com>

data communications due to their speed and affordability.[26] Again, this reduces the need for access lines and the number of households that subscribe to multiple lines. For example, in SBC's territory, Cox Communications is already offering cable modem service in Oklahoma City, Oklahoma and has announced plans to begin offering voice telephony in 1999.[27] When Cox upgrades its Oklahoma City network to provide full two way voice telephony, it could gain up to 20 percent market share of residential local exchange subscriptions.[28]

None of these factors are taken into account in the FCC's market share estimates. Even without any price cap regulation, the existing and likely near term degrees of competition in local exchange markets is greater than that cited by the FCC and is increasing sharply. This would reduce ILECs' abilities to pass on uneconomic costs to consumers via depreciation rates, particularly in certain market segments. The next section explains how these same competitive factors, and the increasing pace of technological innovation, are shortening economic depreciation lives and making regulatory depreciation forecasts impractical.

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[26] Cable modems offer download speeds of up to 2.5 Mbps for downstream and upstream communications with the capability for faster connection speeds dependent on hardware specifications. MSOs are typically offering the service for approximate $40 to $60 per month.

[27] Bob Vandewater, "Cox Cable Provider Hoping to Tap Into Local Phone Market," *The Sunday Oklahoman*, Business and Real Estate, November 1, 1998.

[28] 20% is based on Cox's penetration rate in the part of Orange County where Cox has been offering cable telephony the longest. (See "Cox Achieving Near 20% Penetration," *Cable Carrier News*, April 20, 1998. <www.catv.org>)

IV. Accurate Prescription is Increasingly Difficult Given the Pace of Technological Change and Competition

A. FCC Prescribed Depreciation Life Ranges Are Not Forward Looking

The FCC has taken steps to make its depreciation projections more forward looking than their previous methodologies. As the Commission notes in the NPRM:

> We determined that by paying closer attention to company plans, technological developments, and other future-oriented analysis, more realistic forecasts could be made, and we have since adopted those recommendations.[29]

However, despite these steps, the Commission's depreciation prescription process is *undeniably backward looking* and results in uneconomically long depreciation lives. In the NPRM, the Commission only proposes to shorten the lower end of the depreciation life range for digital switching and not any other category of capital investments. To support this proposal, the only analysis the NPRM cites is a review of plant retirement rates and not an analysis of forward looking competitive, market and technological factors.[30] All other depreciation life ranges set in 1995 are retained in the NPRM, despite the fact that these lives were last set in 1995.[31] This means that the depreciation life ranges were set prior to the passage of the Telecommunications Act, prior to the successful deployment of PCS services, and prior to emergence of the Internet as a

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[29] NPRM, Footnote 6, p. 2.

[30] "We have reviewed recent industry data and have concluded that, except for the digital switching equipment account, we have no evidence indicating that the current ranges are either too long or too short. [Footnote 42] For example, ARMIS data shows that the retirement rates (i.e., annual retirements divided by average plant balances) for telephone plant are approximately the same level as they were ten years ago," NPRM, p. 8.

[31] I understand that individual ILECs can and do, on a case-by-case basis, petition the Commission to use depreciation lives that fall outside the Commissions prescribed ranges. However, these petitions are costly and have uncertain outcomes.

critical and widely-used piece of the nation's telecommunications infrastructure. The following are a few of the causally interrelated factors which make depreciation forecasting extremely difficult in today's environment:

- the increase in competition (discussed above in Section III.B)
- federal and state public policy changes,
- the accelerating pace of technological change,
- uncertainty about the diffusion rates of new technologies.

There is no way that depreciation life ranges set in 1995 could take into account the myriad of changes listed above and still be forward looking today. Figure 1 below provides a comparison of the FCC prescribed depreciation life ranges for ILECs and the depreciation lives used by competitors. Figure 1 shows that even the FCC's most recently updated prescribed ranges from 1995 are much longer than lives for similar plant categories used by ILEC competitors.

Figure 1
Comparison of FCC Prescribed Depreciation Ranges for ILECs with Competitors Economic Lives (in years)

Plant Category	FCC Prescribed Range	AT&T	Electric Lightwave	TCG
Digital Switching	13-18	9.7	10	10
Digital Circuit	8-13	7.2	10	8
Fiber Optic Cable	25-30	20	20	20

Sources:
--FCC Prescribed range for digital switching from: FCC NPRM, July 22, 1998, CC Docket No. 98-137.
--FCC prescribed ranges for all other plant categories from FCC Third Report and Order, May 5, 1995, CC Docket No. 92-296.
--Depreciation rates for AT&T, ELI and TCG as of 1995 from: Testimony of Robert Harris On Behalf of U S West Communications Inc. Before the Arizona Corporation Commission, AT&T-U S WEST Interconnection Arbitration, Docket No. U2428-96-417, September 30, 1996, p. 38.

Let me emphasize that in order for depreciation lives to be forward looking, they must attempt to estimate the likely competitive developments which will occur during the life of the asset. For example, if 20 year depreciation lives were set for an asset based on the level of competition existing today but in a few years competition is likely to intensify reducing the asset's life to 10 years, the 20 year life estimate would not be forward looking.

B. Increasing Competition Shortens Depreciation Lives

I believe it is important to elaborate on why increases in competition have shortened depreciation lives and increased forecasting uncertainty. Increasing competition and the corresponding technological changes along with the competitive responses of incumbents and new entrants are factors that have an impact on economic depreciation lives and make the FCC's regulatory prescription increasingly unreliable.

Economic depreciation should fundamentally reflect forward looking competitive conditions in the market, and those conditions have undergone a sea-change since 1995. Specifically, when a market moves from an environment with heavy regulation and legal barriers to one in which entry is permitted and competition is encouraged (such as was the case for the ILECs after the passage of the Telecommunications Act of 1996), there will be an increased demand for the most capable and efficient productive assets. For the telecommunications industry, this means that there has been increased demand for switching equipment with advanced features, for circuitry, for cable, for fiber optics, and for all other inputs into the production of telecommunications services. This increased demand will attract capital to the firms and industries that produce this equipment

(Lucent Technologies, Siemens, Ericsson, and Motorola to name a few, as well as new entrants newly attracted into those businesses).

As competition heats up in the market for telecommunications services, and as new entrants arrive, adoption of new technologies is likely to quicken. This further encourages new investment by upstream equipment suppliers in R&D activities. The outcome is an enhanced pace of technological progress.[32] In a seminal paper, Nobel Laureate Kenneth Arrow showed that the incentive to innovate is greater when the industry employing the innovation is competitive than when it is monopolistic.[33]

In summary, basic economic principles dictate that when a market makes a discrete, parametric shift toward a more competitive environment – such as occurred with the passage of the Telecommunications Act of 1996 – plant and equipment will become obsolete faster as competition stirs technological innovation in equipment supply markets. The inevitable counterpart of enhanced technological progress is a more rapid rate of obsolescence for existing plant and equipment. This is likely to be true of both existing capital equipment and future capital equipment.

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[32] The enhanced investment in R&D in the market supplying the equipment would be expected independent of how competitive is the market supplying the equipment. In economic terms, the pace of technological change would reflect both supply conditions (competitiveness in the equipment market) and demand conditions (competitiveness in the telecommunications services market); not the former alone, as some have erroneously claimed.

[33] Kenneth J. Arrow, "Economic Welfare and the Allocation of Resources for Invention," in *The Rate and Direction of Inventive Activity: Economic and Social Factors*, Report of the National Bureau of Economic Research, (Princeton: Princeton University Press, 1962), p. 609-626.

C. *Unpredictable Technological Diffusion Rates Require Regular Adjustment of Depreciation Lives*

Regulators often acknowledge that technological change requires faster depreciation of assets, but complain that incumbents have not specifically identified when and which technological changes will take place. In my judgment, regulators are asking for the impossible. No one can predict with certainty where innovation will take place. Research is by nature risky, uncertain, and surprising. Progress in wireless, in broadband cable, in satellite technology, and in Internet applications, may each have significant effects on traditional telephony in the near future. But it is just as likely that there will be competitive inroads from some other, less obvious direction. How competition and technological innovation evolve is unpredictable. What is predictable is that they will evolve, and economic forces further propel the market toward technological progress.

Even in the past, when technology was changing more gradually, there was tremendous uncertainty about the actual diffusion rates technologies would enjoy. For example, in 1981 AT&T famously predicted that by the end of the century there would only be 900,000 cellular subscribers.[34] As of year-end 1997, there were already over 52 million wireless subscribers and more current forecasts predict over 90 million subscribers by 2000.[35] This, and the other technological advances I described earlier, increase uncertainty in today's world.

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[34] Fleming Meeks, "Would You Believe it? Craig McCaw Says He is Risk-Averse," *Forbes*, March 1, 1993, p. 78.

[35] "The Wireless Communications Industry," *Donaldson, Lufkin & Jenrette*, Spring 1998, Table 1 & Table 4.

For example, the widespread adoption and increasing commercial importance of the Internet is likely to have powerful and hard to predict implications for local exchange companies' depreciation rates. On the one hand, today's customers are increasingly demanding multiple residential telephone lines for their growing Internet uses. Incumbent LECs are also rolling out xDSL technologies on their local exchange networks that they hope will extend the economic lives of a large portion of their existing plant by providing high speed data connections to the Internet. However, other countervailing technologies may effectively compete against xDSL services, thereby reducing the life of existing plant.[36]

Because of rapid and unpredictable changes in technology diffusion rates, it makes sense for the individual firms themselves, those who are most aware of the market conditions in which they are operating, to set their own depreciation lives with ad hoc reviews by regulators when necessary. Cumbersome and lengthy regulatory proceedings are unnecessary and impractical.

V. Conclusion

The communications revolution emanated from explosive changes in digital and other technology. As FCC Commissioner Powell has pointed out, traditional market barriers

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[36] For example, the cable-modems mentioned earlier being deployed by companies like AT&T/TCI, Time Warner, Cox and others offer substantially higher speed transmission rates than xDSL technologies. Additionally, satellite and other wireless connections to the Internet such as Direct PC may increasingly leave local telephone companies technologies outmoded. The competitive significance of cable modem has only recently become apparent. As little as five years ago nobody considered them to be an important factor in the telecommunications environment.

have started to crumble. He said, "Now it is possible for providers of traditionally distinct technologies and services to cross into new markets and attack each other with a panoply of applications and services."[37] The crossover of new and related technologies into local telecommunications markets, in addition to the invigorated competitive environment, makes it necessary to take an appropriately broad view when reviewing regulation such as the FCC's depreciation prescription process for price-cap ILECs.

I believe that the FCC should remove the depreciation prescription process for price cap companies because the costs of this regulation are greater than the benefits. A basic tenet of public policy economics calls for policy makers to perform a cost-benefit test to evaluate the possible positive results of regulation. If the benefits of the regulation do not exceed the costs, the regulation should not be put into effect. I believe that the evidence cited above shows that the costs of the depreciation prescription process far outweigh the benefits.

Clearly, the time and costs of this regulation are a great burden to both the FCC and the ILECs. Changes in Federal price cap rules constrain their ability to modify pricing to recover changes in costs. This combined with the developing competitive environment means that there is no need to continue depreciation prescription as a protective garment. New technologies are inspiring competitors to enter the local exchange market and challenge wireline service providers. Additionally, the rapid pace of technological

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[37] Michael K. Powell, Commissioner of the Federal Communications Commission. "Technology and Regulatory Thinking: Albert Einstein's Warning" (As Prepared For Delivery). Speech before the Legg Mason Investor Workshop, Washington, D.C., March 13, 1998. <www.fcc.gov>

change indicates that it is increasingly difficult to accurately assess prescribed depreciation lives. Given this evidence, I conclude that the FCC should eliminate the depreciation prescription.

CERTIFICATE OF SERVICE

I, Katie M. Turner, hereby certify that the foregoing, "CC DOCKET NO. 98-137, COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL IN THE MATTER OF 1998 BIENNIAL REGULATORY REVIEW – REVIEW OF DEPRECIATION REQUIREMENTS FOR INCUMBENT LOCAL EXCHANGE CARRIERS AND ASD 98-91, FORBEARANCE FROM DEPRECIATION REGULATION OF PRICE CAP LOCAL EXCHANGE CARRIERS," in CC Docket No. 98-137 has been filed this 23RD day of November, 1998 to the Parties of Record.

Katie M. Turner

November 23, 1998

Ernestine Creech
Accounting Safeguards Division
2000 L Street, N.W.
Suite 200
Washington, DC 20036

Lawrence E. Sarjeant
Linda Kent
Keith Townsend
John Hunter
U.S. Telephone Association
1401 H Street, N.W.
Suite 600
Washington, DC 20005

William F. Maher, Jr.
Halprin, Temple, Goodman & Sugrue
1100 New York Avenue, N.W.
Washington, DC 20005

ITS
1231 20th Street, N.W.
Ground Floor
Washington, DC 20036

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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Forbearance from Depreciation Regulation	)	ASD 98-91
of Price Cap Local Exchange Carriers	)	

COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL[1]

A comprehensive review of depreciation regulation is long overdue. The dramatic legislative, regulatory, market and technological changes that have occurred since the last review in 1993 require a massive overhaul and radical simplification of the Commission's depreciation regulation. In fact, as a result of the changes in the regulation of price cap incumbent local exchange carriers ("ILECs"), the Commission should remove itself completely from the prescription of their depreciation rates. USTA's Petition for Forbearance (the "USTA Petition") shows that price cap ILECs satisfy the criteria for forbearance from depreciation regulation. In addition to granting the price cap ILECs forbearance, if the Commission is going to continue regulating the depreciation practices of other ILECs, it should conduct a comprehensive review of the life ranges adopted in 1993. It should also significantly streamline, if not eliminate, the depreciation prescription process for any ILECs that are not granted forbearance.

[1] Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell ("SBC LECs") are filing these Comments pursuant to the Commission's Notice of Proposed Rulemaking ("NPRM") in the above-captioned proceeding adopted on July 22, 1998 and released on October 14, 1998 and the Public Notice dated October 16, 1998, DA 98-2092, requesting comments on the Petition for Forbearance filed by the United States Telephone Association ("USTA") on September 21, 1998.

If the Commission does not forbear completely from applying its depreciation regulation to price cap ILECs, it should, at a minimum, permit them to use a price cap carrier option like the one proposed by the Commission in 1992.[2] Under that option, the price cap ILEC is not limited by any ranges. Further, the only information to be routinely filed under that option would be the existing and proposed depreciation rates and the resulting change in depreciation expense.

A price cap carrier option should be adopted only if immediate forbearance is not granted and should be considered only a short-term transitional step toward complete deregulation of price cap ILECs' depreciation practices.

While the standards are different for forbearance and biennial review, the result of the analysis of depreciation is the same: depreciation regulation of price cap ILECs is unnecessary. Under the Section 10[3] standard, while the pro-competitive benefits of discontinuing depreciation regulation weigh in favor of forbearance in the public interest, forbearance is justified regardless of the level of competition. Under the Section 11[4] standard, the level of meaningful economic competition is sufficient—in light of the price cap regulatory model—that continuing to regulate price cap ILECs' depreciation rates is no longer justified by its minimal benefits. In the case of price cap ILECs, it is not necessary for the Commission to measure the intensity of competition before granting relief from price cap regulation because, with the elimination of sharing, there is no good reason to continue regulating price cap ILECs' depreciation rates. Accordingly, the Commission need not reach the Section 11 analysis of price cap ILECs' depreciation regulation; instead, the Commission should conclude that the Section 10 standard for forbearance is satisfied by the circumstances of price cap ILECs.

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[2] Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Notice of Proposed Rulemaking, 8 FCC Rcd 146, 152-53 ¶¶40-43 (1992) ("1992 Depreciation NPRM").

[3] 47 U.S.C. § 160.

[4] Id. § 161.

I. THE COMMISSION SHOULD REMOVE ITSELF COMPLETELY FROM THE PRESCRIPTION OF DEPRECIATION RATES OF PRICE CAP ILECS.

As part of the Section 11 biennial review of Commission regulations, the NPRM presents two principal proposals regarding depreciation.[5] First, the NPRM proposes to streamline the depreciation process in certain limited respects, such as permitting summary filings, and expanding the prescribed life range of only one out of the 34 plant categories.[6] These meager proposals fall far short of the comprehensive review of depreciation practices that the industry has been anticipating for some time. Second, the NPRM proposes to permit price cap ILECs to set their own depreciation rates provided (i) they waive the low-end adjustment; and (ii) the Commission resolves its concerns about the need to prescribe depreciation rates for several purposes described in paragraph 6 of the NPRM.[7]

SBC concurs with USTA's Petition that there is no good reason to continue prescribing the depreciation rates of price cap ILECs. In its Petition, USTA has explained very well how regulation has evolved to the point that the Commission can no longer justify depreciation regulation in terms of its originally anticipated benefits.[8] Depreciation regulation served a purpose under a rate-of-return regulatory system. When price cap regulation went into effect in 1990, depreciation regulation became far less important. However, because of the sharing mechanism in the original LEC price cap plan, depreciation rates still played a role in the calculation of sharing obligation, except for those LECs that adopted a "no sharing" option. Given that sharing was eliminated in 1997, the last remaining significant link between prices and costs has been severed. In fact, one of the main reasons for adopting price cap regulation and eliminating sharing was to avoid "administratively burdensome" regulations such as those

[5] NPRM, ¶1.

[6] Id., ¶¶9-11.

[7] Id., ¶¶8, 18.

[8] USTA Petition at 5-8.

governing depreciation.[9]

When the Commission last reviewed the depreciation regulations five years ago, the Commission adopted a limited degree of simplification for price cap ILECs by permitting them to use the Basic Factor Range Option. But, in the 1993 Depreciation Simplification Order,[10] the Commission refused to adopt a significant degree of simplification for price cap ILECs because of the sharing mechanism.[11] In contrast, the Commission gave AT&T significant relief from the depreciation requirements primarily because AT&T's price cap plan did not have a sharing mechanism.[12] The Commission permitted AT&T to use a modified version of the price cap carrier option.

Sharing stood as an obstacle to meaningful depreciation simplification for price cap ILECs. That obstacle was removed by the Commission's decision to eliminate sharing in 1997. That change, when considered in conjunction with the dramatic changes in the telecommunications market as a result of the Telecommunications Act of 1996 and the Section 10 and Section 11 mandates for regulatory reform, lead to the conclusion that price cap ILECs should no longer be required to comply with unnecessary regulations such as those governing depreciation, or at a minimum, depreciation rules should be radically simplified.

USTA correctly observes that, as a result of the elimination of sharing, the justification for depreciation regulation articulated in the 1993 Depreciation Simplification Order ceases to

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[9] 1998 Biennial Regulatory Review – Part 61 of the Commission's Rules and Related Tariffing Requirements, CC Docket No. 98-131, Notice of Proposed Rulemaking, FCC 98-164, released July 24, 1998, n. 23. Price Cap Performance Review for Local Exchange Carriers, 12 FCC Rcd 16642 ¶¶146, 150-152 (1997) ("1997 Price Cap Review Order").

[10] Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, 8 FCC Rcd 8025 (1993) ("1993 Depreciation Simplification Order").

[11] Id., ¶42-44, 47.

[12] Id., ¶92.

exist.[13] As a result of the elimination of sharing, depreciation regulation of price cap ILECs is no longer essential to ensure just and reasonable rates or to protect consumers, under the standard for forbearance in Sections 10(a)(1) and (2). Further, as USTA explained, forbearance is consistent with the public interest because there is very little, if any, benefit in applying depreciation regulation to the price cap LECs and this regulation places a very costly and inequitable burden on the price cap LECs.[14]

The 1993 Depreciation Simplification Order focused on the sharing mechanism as the most important distinction between price cap ILECs and AT&T. Sharing was the difference between limited streamlining for the price cap ILECs and significant relief from regulation given to AT&T. In contrast, at a time when the Commission should be eliminating all unnecessary regulations, the Commission has suggested that there are now as many as seven potential reasons for either continuing to prescribe the depreciation rates of price cap ILECs or imposing conditions to obtain relief from depreciation prescription. It is counter-intuitive that, under the deregulatory national policy framework of the 1996 Act, the number of reasons to retain burdensome depreciation regulation would multiply rather than shrink, compared to the less competitive and more regulatory environment in 1993, when the Commission only identified one significant obstacle to meaningful deregulation – sharing. It is also strange that most of these additional reasons are not based on new developments or new regulations that did not exist in 1993. If these are legitimate concerns now, it is unclear why they were not raised as obstacles to simplification for AT&T and the price cap ILECs in 1993.

In view of the elimination of sharing and the escalating competitive pressures, price cap ILECs cannot, as a practical matter, impose any increases in depreciation expense on

[13] USTA Petition at 11.

[14] Id. at 16-18.

their ratepayers. Therefore, the limited potential benefits of depreciation regulation no longer justify the burdensome and costly prescription process.

II. THERE IS NO GOOD REASON TO CONTINUE REGULATING PRICE CAP ILECS' DEPRECIATION RATES.

According to the NPRM, depreciation regulation is still significant for price cap ILECs in several situations including the low-end adjustment, productivity factor calculations, exogenous cost adjustments, the Base Factor Portion calculation, above-cap filings, universal service cost models and interconnection rates.[15] Thus, the NPRM inquires as to what conditions the Commission could impose to resolve its concerns about these other contexts so that it could permit price cap ILECs to set their own depreciation rates.[16] In SBC's view, none of these situations justify retaining burdensome depreciation regulation. In spite of the Commission's apparent belief that depreciation remains a significant factor in these contexts, SBC submits that none of these is a good reason to continue to require price cap ILECs to follow burdensome depreciation prescription procedures. Even after the limited streamlining of procedures proposed in the NPRM, the procedures would still impose an excessive burden that would not be justified by any of the reasons identified in the NPRM. The NPRM asks, under what conditions carriers should be allowed to set their own depreciation rates "even in the absence of full competition." As explained below, depreciation regulation is no longer essential for the Commission's oversight and regulation of price cap ILECs. Thus, especially in view of the unnecessary burden of depreciation regulation, forbearance or, at a minimum, the price cap carrier option are required.

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[15] NPRM, ¶6.

[16] Id. ¶8.

A. The Low-End Adjustment

The low-end adjustment was not considered an obstacle to simplification in the 1993 Depreciation Simplification Order. Now, the NPRM seeks to impose as a condition of depreciation deregulation that price cap ILECs must waive the automatic low-end adjustment.[17]

More specifically, the NPRM seeks comment on a BellSouth proposal presented to the Commission staff on April 8, 1998. While the NPRM states that BellSouth proposed the condition that price cap ILECs "not seek an automatic low-end adjustment,"[18] what BellSouth's April 8, 1998 filing actually said on the subject was the following:

> Price Caps – FCC can Require that Low-end Earnings Adjustments be based on Most Recently Prescribed Lives or at Minimum, FCC can Review Lives with Low-end Filing[19]

In effect, BellSouth was suggesting that the Commission could forbear from regulating depreciation rates because the low-end adjustment need not be automatic. The SBC LECs agree with the rationale of BellSouth's April 8, 1998 filing. If the Commission reserves the right to review depreciation rates at the time of any low-end adjustment filing or to use the most recently prescribed rates, then there is no reason to continue to prescribe depreciation rates for all price cap ILECs. By adopting this approach, the Commission would retain a narrowly tailored control over depreciation regulation only when this control is truly necessary and without burdening those ILECs for which the control is superfluous.

Depreciation prescription is especially unnecessary for purposes of the low-end adjustment given that low-end adjustment filings are very rare. In fact, only a few ILECs have used the low-end adjustment and no one has used it recently.

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[17] NPRM, ¶¶8, 18.

[18] Id., ¶8 (emphasis added).

[19] BellSouth Telecommunications Ex Parte on Depreciation Biennial Review and Forbearance (April 8, 1998), Tab I, ¶5.

Further, as the SBC LECs have been arguing in price cap proceedings, cost-based elements should be removed from the price cap plan.[20] The object of price cap regulation should be the reasonableness of changes in the overall level of prices, not on earnings. Provided the Commission permits sufficient pricing flexibility and a reasonable productivity factor as described in the SBC LECs' access reform filings, the low-end adjustment should be eliminated. In fact, SBC and USTA have recommended such elimination as part of an access reform transition plan.[21]

Otherwise, to the extent the low-end adjustment is not eliminated, the Commission does not need to continue prescribing depreciation rates for all price cap ILECs because it can review the depreciation rates of any ILEC that seeks a low-end adjustment at the time of its filing. Accordingly, price cap ILECs should be allowed to set their own depreciation rates, without any ranges or other constraints and without any prior Commission review.

B. Recalculation of the X-Factor

The NPRM suggests that prescription of depreciation rates may be necessary for purposes of recalculating the productivity component of the X-Factor.[22] In making this suggestion, the NPRM cites the Price Cap Fourth R&O's decision to use prescribed depreciation rates in the Total Factor Productivity ("TFP") calculation.[23] However, in the over-all calculation of the X-Factor of the Commission's productivity model, changes in depreciation rates do not have any

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[20] See SWBT Reply Comments, CC Docket No. 94-1, filed March 1, 1996 at 6; SWBT Comments, CC Docket No. 94-1, filed May 9, 1994 at 43-44.

[21] USTA Comments, CC Docket Nos. 96-262, 94-1, 97-250 & RM-9210, filed October 26, 1998, Attachment A, at 31; SBC LEC Comments, CC Docket Nos. 96-262, 94-1, 97-250 & RM-9210, filed through ECFS October 26, 1998 at 17; SBC LEC Reply Comments, CC Docket Nos. 96-262, 94-1, 97-250 & RM-9210, filed through ECFS November 9, 1998, n. 41.

[22] NPRM, ¶6.

[23] Price Cap Performance Review of Local Exchange Carriers, 12 FCC Rcd 16642, 16670 (1997) ("Price Cap Fourth R&O").

net impact.

An increase in depreciation rates has no impact on the X-Factor because such an increase causes two components of the X-Factor to change in opposite directions by equal amounts: the productivity component will decline and the input price component will increase by exactly the same amount. The result is a net impact of zero on the X-Factor.

The productivity component, which is defined as the difference between LEC productivity and U.S. productivity, declines when depreciation rates rise because the amount of capital used up in each period will increase thereby causing LEC measured productivity to decline. A decline in LEC productivity will cause the difference between LEC productivity and U.S. productivity (i.e., the productivity differential) to decline.

Conversely, the input price component, which is defined as the difference between U.S. inflation and LEC input price inflation, increases as a result of increases in depreciation rates. This occurs because the LEC input price inflation; which is the difference between the percent change in the nominal dollar value of LEC inputs and the weighted average of changes in input quantities of labor, capital and materials; decreases as a result of an increase in depreciation rates.[24] A decrease in LEC input inflation will cause the input price differential to increase.[25]

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[24] The closed structure of the Commission model guarantees that the nominal dollar value of LEC inputs does not change as a result of changes in depreciation rates. As described above, increasing depreciation rates will cause the quantity of capital used in each period to increase. Thus, the difference between the nominal dollar value of LEC inputs (which is constant) and the total quantity of inputs (which increases when depreciation rates are increased) causes LEC input inflation to decline. Thus, the difference between LEC input inflation and U.S. inflation will increase as a result of increases in depreciation rates.

[25] The closed structure of the Commission model guarantees that the input price differential will always change by the same amount in the opposite direction as the productivity differential as a result of changes in LEC depreciation rates.

Accordingly, when the entire X-Factor calculation is considered, a change in general level of LEC depreciation rates would not result in any change in the X-Factor. Therefore, the TFP and X-Factor are no reason to continue prescribing depreciation rates.

C. Exogenous Cost Determinations

Citing the Price Cap Second R&O,[26] the NPRM suggests that prescription of depreciation rates may be necessary for purposes of future exogenous cost adjustments. It is unclear how this could be so, given that the Price Cap Second R&O determined that "cost changes due to changes in depreciation rates are endogenous."[27] Thus, price cap ILECs could not benefit from an exogenous cost adjustment resulting from a change in depreciation rates.

The Commission has narrowed the circumstances that would permit an exogenous cost change by imposing additional conditions.[28] Also, the price cap plan should be moving away from cost-based determinations and, instead, should rely on market-based factors.

In the limited instances that an exogenous cost adjustment is still possible, it is not clear how depreciation rates could be a factor. Even if depreciation rates could indirectly affect an exogenous cost determination, the Commission should use the approach suggested above for the low-end adjustment. That is, at the time of the exogenous adjustment, the Commission could either use the latest prescribed depreciation rates or review the ILECs' depreciation rates for reasonableness.

Accordingly, exogenous cost determinations are no reason to continue prescribing depreciation rates.

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[26] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6809 (1990) ("Price Cap Second R&O").

[27] Id. ¶82.

[28] See, e.g., Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8961 ¶¶293-294 (1995).

D. Base Factor Portion Calculation

The NPRM suggests that prescription of depreciation rates may be necessary for purposes of calculating the Base Factor Portion ("BFP") component of the common line revenue requirement.[29] However, in the access reform proceeding, the Commission has decided to phase out the per-minute common line charges.[30] Upon elimination of the per-minute charges, the BFP component would be determined by an entirely revenue-based calculation. Thereafter, the BFP component will no longer be a cost-based calculation and, thus, changes in depreciation rates would not have any impact on common line charges.[31]

Thus, the BFP calculation should not be used as a pretext for retaining burdensome depreciation regulation.

E. Above-Cap Filings

The NPRM suggests that depreciation prescription may be necessary for purposes of the cost support an ILEC would be required to submit for an Actual Price Index ("API") above its Price Cap Index (i.e., an above-cap filing).[32] Above-cap filings are even more rare than low-end adjustment filings.

In the rare event of an above-cap filing, the ILEC would have the burden of providing all of the necessary cost support to substantiate its requested API.[33] Thus, the Commission could

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[29] NPRM, ¶6.

[30] Price Cap Fourth R&O, 12 FCC Rcd at 16709, ¶170.

[31] Another component that relies, to some extent, on the BFP calculation is the residual PICC. However, SBC concurs with USTA's recommendation to modify the PICC calculation so that it is also revenue-based. See USTA Petition for Rulemaking, 1998 Biennial Regulatory Review, September 30, 1998 at 53.

[32] NPRM, ¶6.

[33] 47 C.F.R. ∋ 61.49(e).

review the depreciation rates, along with the necessary data to support those rates, at the time of any such filing. Given the ability to perform a case-by-case review of the cost support, an extremely rare above-cap filing is no reason to continue regulating the depreciation practices of all price cap ILECs.

F. Universal Service

The NPRM suggests that changes in depreciation rates may affect the calculation of federal universal service support payments.[34]

While the Commission is still in the process of designing the model for estimating the cost of providing federally supported services, it has chosen to use a forward-looking economic cost model that assumes an ILEC has a hypothetical network using the least-cost, most efficient technology available.[35] Using the prescribed depreciation rates that are based on an ILEC's actual investment and retirement data is illogical given that these actual rates will be applied to the hypothetical costs of a hypothetical ILEC used in the model platform. Since the Commission has specifically rejected the use of ILECs' embedded costs to calculate high cost support,[36] it would not make sense to use depreciation rates that are largely determined based on those embedded costs and backward-looking retirement data.

In fact, under the Commission's current procedures, the prescribed depreciation rates are almost entirely based on historic data such as past retirement patterns. Whenever the SBC LECs have sought forward-looking depreciation rates in recent three-way meetings, the Commission

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[34] NPRM, ¶6.

[35] Federal-State Joint Board on Universal Service, 12 FCC Rcd 8776 (1997) ("Universal Service Order").

[36] Federal-State Joint Board on Universal Service, Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, CC Docket No. 97-160, Fifth Report and Order, FCC 98-279, released October 28, 1998, ¶10. ("USF Platform Order").

staff has insisted on historic proof to support life and salvage factors.[37] In prescribing depreciation rates, the Commission has relied almost exclusively on past mortality experience, rejecting forward-looking analyses that support shorter economic lives than those prescribed by the Commission.

If the Commission is going to use a forward-looking hypothetical cost model, then it should use forward-looking economic depreciation rates, not those ranges or rates it has adopted or prescribed in the past.

In fact, for purposes of the hypothetical cost model, it is not necessary to prescribe actual depreciation rates for individual ILECs, as it is very unlikely that individualized depreciation rates would have any rational relationship to the hypothetical investment and costs used in the model. Therefore, under the current framework, universal service high cost support calculations are no reason to continue prescribing depreciation rates.

G. Interconnection and Other Local Pricing

Interconnection and other local pricing is also no reason to retain federal depreciation regulation. Any local pricing regulation is beyond the Commission's jurisdiction.[38] The Commission should not limit forbearance or streamlining based on a belief that state regulators might find a federal accounting rule or procedure to be useful for state purposes. Those few states that still need detailed accounting data for rate-of-return style regulation have the authority to continue regulating depreciation rates independent of the Commission's forbearance decision. However, interconnection rates are supposed to be "determined without reference to a rate-of-return or other rate-based proceeding."[39]

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[37] See, e.g., Letter dated January 16, 1998 from Ms. Fatina K. Franklin, FCC, to Ms. Jane E. Knox, SBC (requesting detailed retirement and mortality data for 1998 depreciation study.)

[38] Iowa Utilities Board v. FCC, 120 F.3d 753 (8th Cir. 1997), cert. granted.

[39] 47 U.S.C. § 252(d)(1)(A).

Only a minority of states continue to use rate-of-return style regulation and the number is on the decline. All but two of the seven states in which the SBC LECs operate have adopted price cap regulation and the two remaining states, Oklahoma and Nevada, have rate moratoria. Further, the states are beginning to recognize that it is not necessary to prescribe depreciation rates for purposes of state regulation. For example, as part of its new regulatory framework decision released on October 8, 1998, the California Public Utilities Commission ("CPUC") permanently eliminated the annual depreciation reviews and approvals for Pacific Bell and GTE.[40] The CPUC reasoned that depreciation regulation was "largely necessary only in connection with sharing."[41]

H. Fifth Amendment Takings Clause Claims

The NPRM's last suggested reason for needing to prescribe depreciation rates, even under price cap regulation, is that depreciation "may play a role in a takings claim under the Fifth Amendment."[42] Although it is not clear what takings claim the Commission believes would require depreciation regulation to continue, in the event an ILEC filed a takings claim, it would have the burden of proving the measure of just compensation.[43] If the Commission provides an adequate process for obtaining compensation for takings resulting from the 1996 Act or regulation,[44] the ILEC could be given the burden of showing that its depreciation is reasonable as part of the proof of compensation. While depreciation may be necessary to calculate the value of

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[40] Final Opinion, R. 98-030-040, CPUC, October 8, 1998, § 6.1 et seq, at 50-58, 92 ("CPUC NRF Decision").

[41] Id. § 6.2 at 51.

[42] NPRM, ¶6.

[43] See United States v. John J. Felin & Co., Inc., 334 U.S. 624, 631 (1948).

[44] See MCI Telecommunications Corp. v. Pacific Bell, 1998 U.S. Dist. LEXIS 17556, No. C97-0670 SI, September 29, 1998.

property taken, it is certainly not necessary for the Commission to continue regulating depreciation for purposes of a future takings claim.

On the contrary, continuing to prescribe depreciation rates that do not permit ILECs to fully recover their investments would not be in the public interest because it would increase the under-depreciated amount that could be the subject of a takings claim.

In fact, this was one of the factors that lead the CPUC to permanently eliminate its depreciation reviews and approvals beginning January 1, 1999. As the CPUC stated,

> We also agree with many commenters who say eliminating depreciation approvals will mitigate the stranded cost . . . problem.[45]

The Commission likewise has spoken of the need to address the ILECs' historical or embedded cost recovery, that is, according to the Commission, "whether and to what extent carriers should receive compensation for the recovery of allocated costs of past investments if competitive market conditions prevent them from recovering such costs . . .."[46] And, the Commission has recognized, at least in theory, that a deficiency in cost recovery may be traceable to past regulatory practices such as separations policy and under-depreciation.[47] Past depreciation practice has contributed to a deficiency in the recovery of investment because, by prescribing unrealistically long lives, the Commission's prescribed depreciation rates have allocated the historical investment to each period for regulatory purposes in a manner that did not permit sufficiently rapid recovery.

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[45] CPUC NRF Decision, § 6.2.1 at 53.

[46] Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Restructure and Pricing; End User Common Line Charges, 12 FCC Rcd 10175 n.25 (quoting Access Reform Order, ¶14). See also Universal Service Order, 12 FCC Rcd at 8869-70, ¶167.

[47] Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing and Usage of the Public Switched Network by Information Service and Internet Access Providers, 11 FCC Rcd 21354 ¶¶248-259 (1996).

For these reasons, among others, the possibility of a takings claim does not provide any reason whatsoever to retain any federal regulation of depreciation rates. The potential for takings claims based on the under-depreciation of investments subject to Commission regulation is yet another reason supporting discontinuation of the current system of depreciation prescription.

III. TO THE EXTENT THE COMMISSION CONTINUES TO PRESCRIBE ANY ILECS' DEPRECIATION RATES, A COMPREHENSIVE REVIEW OF DEPRECIATION REGULATION AND BASIC FACTOR RANGES IS REQUIRED.

The NPRM proposes a few changes to its depreciation regulation in the event it continues to prescribe depreciation rates for some ILECs.[48] While the Commission should remove itself completely from the process of prescribing depreciation rates for price cap ILECs, and perhaps all ILECs, any remaining regulation needs to be streamlined and updated to a much greater degree than the NPRM proposes. For some time now, the Commission has been promising to

[48] NPRM, ¶9.

conduct a comprehensive review of its depreciation process.[49] In fact, in 1993, when it completed the last comprehensive review, the Commission stated as follows:

> We therefore intend to institute a further proceeding as expeditiously as possible to explore ways in which our depreciation process and policies can become more responsive to actual changes in patterns of LEC investment and plant retirement.[50]

This expeditious proceeding never occurred. In the 1993-1995 depreciation simplification rulings, the Commission was still contemplating a predominantly historical approach. Thereafter, the Commission repeatedly referenced an imminent comprehensive review, but the review never began. Now that Congress has mandated a biennial review, the Commission has undertaken one, but it can hardly be called comprehensive. The NPRM only

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[49] A number of Commission statements regarding depreciation regulation have indicated that a comprehensive review of depreciation and other proceedings were going to be conducted much sooner than 1998. For example, in the 1993 Depreciation Simplification Order, ¶80, the Commission stated as follows:

> We are persuaded that a three year review is necessary to keep ranges in line with technological, demand, and competitive changes. Therefore, barring unforeseen regulatory, market, or technological changes, we will begin a review of the range set for a given account three years after the range is introduced.

Further, in the 1993 order, the Commission stated that "within three years it would begin a review of the ranges it adopted." Id. In the 1993 order, the Commission even recognized that more frequent reviews would be required in the event of "unforeseen regulatory, market, or technological changes." Id.

If the radical changes brought about by the 1996 Act are not the type of regulatory and market changes contemplated in the 1993 order that should have triggered an earlier review of depreciation rules, then the SBC LECs do not know what changes would have accelerated this review.

At the end of 1996, the Commission again promised that it would "commence in the near future a comprehensive review of its depreciation rules" in light of the 1996 Act. The Prescription of Revised Percentages of Depreciation Pursuant to the Communications Act of 1934, as amended, FCC 96-485, released December 20, 1996, ¶2.

[50] 1993 Depreciation Simplification Order, ¶56.

proposes to revise the life range of one out of 34 plant categories. The proposal to reduce the depreciation filing to four summary exhibits is also relatively insignificant because ILECs would still have to prepare all of the same studies to support those four summary exhibits. Merely eliminating the requirement to submit these studies with the initial filing would only provide a token amount of relief from the burden of the depreciation requirements. The NPRM is not proposing to eliminate or simplify the full-blown traditional depreciation study requirements outlined in its Depreciation Study Guide. Instead, it is merely suggesting that ILECs not be required to submit copies of those lengthy studies with their initial filings. Submitting copies of these studies is a relatively insignificant fraction of the over-all burden of the depreciation prescription process.[51] Instead of eliminating only the paper submission, the Commission should eliminate the burden of unnecessary studies.[52]

Likewise, instead of revising only one range, the Commission should conduct a comprehensive review of all ranges. Notwithstanding suggestions to the contrary in the NPRM,[53] the Commission's current depreciation prescription process does not permit development of forward-looking depreciation rates. In fact, when ILECs argued that the Commission should consider forward-looking data in establishing the current ranges, the Commission responded as follows:

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[51] Besides, there is no guarantee that the Commission staff would not insist on receiving copies of the full-blown studies after it reviews the summary filings. Thus, ILECs might not receive any relief at all under this proposal.

[52] Another NPRM proposal that provides even less relief from unnecessary regulation would allow ILECs' revised depreciation rates to go into effect without a prescription order if it selects depreciation factors for all 34 rate categories within the Commission's ranges. In view of the fact that the life ranges are generally too high for a number of accounts, this alternative would not be a viable option for any ILEC, even assuming any ILEC could qualify for lives within the ranges in all 34 accounts. See 1993 Depreciation Simplification Order, n. 35 ("Any factor selected by a carrier should reflect that carrier's operations").

[53] NPRM, ¶3 & n.6.

> In discussing the ranges, many of the commenters recommend that we consider other methodologies, criteria and data in establishing the ranges. For example, the LECs state that we should consider forward looking data rather than historical data. As stated above, these issues are beyond the scope of this FOIC, but will be addressed in the pending reconsideration of the Depreciation Simplification Order.[54]

ILECs must be permitted to use depreciation rates that are based on realistic projections of the retirements and replacements that must take place in an environment of widespread competition and rapid technological change. A wide range of "unforeseen regulatory, market [and] technological changes"[55] have occurred since the 1993 Depreciation Simplification Order that require the Commission to forbear from regulating price cap ILECs' depreciation and to review and revise the ranges of a number of accounts for other ILECs. These radical changes in the landscape have significantly altered the circumstances under which the Commission established life ranges in CC Docket No. 92-296. Those life ranges cannot be considered forward-looking, as the Commission expressly refused to consider a forward-looking approach in CC Docket No. 92-296[56] and since then has refused to consider forward-looking data in its depreciation prescription process.

The Commission's historical retirement pattern approach may have been more appropriate when the primary drivers of mortality were traditional mortality forces such as wear and tear and deterioration. However, technology and new markets are changing telecommunications plant so rapidly that primary reliance on past mortality experience is woefully inadequate. Increasingly, decisions to replace plant are driven by improved economies, evolving technologies and new features and services in telecommunications equipment and information technology. This

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[54] Simplification of the Depreciation Prescription Process, Third Report and Order, 10 FCC Rcd 8442, 8447 n.31 (1995) ("Depreciation Simplification Third R&O"). Of course, because the Commission never issued an order on reconsideration in CC Docket No. 92-296, it never addressed the use of forward-looking, rather than historical, data.

[55] 1993 Depreciation Simplification Order, ¶80.

[56] Depreciation Simplification Third R&O, n.31.

environment is in stark contrast to past periods of long-running stable technologies. Forward-looking factors need to be the predominant consideration. Future declines in economic usefulness need to be considered so that plant costs are allocated over the period in which the plant is able to generate sufficient revenues. Decline in usefulness considers the impact on lives associated with obsolescence from competition, changes in technology, and new service demands.

Competitive factors, an accelerating rate of technological change and other interrelated factors are shortening the lives of network equipment and are making it extremely difficult to estimate the forward-looking lives of that plant. As Dr. Harris explains, "No one can predict with certainty where innovation will take place . . .. How competition and technological innovation evolve is unpredictable. What is predictable is that they will evolve . . .."[57] Significant recent examples are the rapid expansion of the Internet as a vital component of the national telecommunications infrastructure and the related advances in xDSL and cable modem technology. It is not practical for a regulator to keep up with all of these developments and to accurately update its depreciation policy on a regular basis every year. However, if the Commission insists on retaining control of any ILECs' depreciation practices, it must keep up with developments with much greater regularity than in the past, it must develop a truly forward-looking approach and, as a first step, it must adjust all of its life ranges to reflect a new, forward-looking approach.

The NPRM does ask whether life ranges for accounts other than digital switching require revision,[58] but the narrow focus of its proposal for only one of 34 plant categories implies a narrow scope of review. The life ranges of a number of other categories need to be revised. A few of these are discussed below. However, failure to discuss other categories should not be

[57] Statement of Dr. Robert G. Harris, Exhibit "A", at 18.

[58] NPRM, ¶1.

construed as an endorsement of the current ranges of the omitted categories – all 34 categories need to be reviewed for purposes of those ILECs that do not receive forbearance.

For digital switching, the NPRM proposes a range of 13 to 18 years. While this is a step in the right direction that recognizes that the current range (16 to 18) has been outdated, the SBC LECs submit that a range of 7 to 16 is more in line with a forward-looking approach. This recommended life range is based on SWBT's life analysis submitted with its 1998 depreciation rate study. SWBT's analysis considered company strategy and deployment plans, industry studies prepared by Technology Futures, Inc.,[59] lives previously prescribed for AT&T and lives used for financial reporting by major ILECs.

Based on these factors, SWBT's study showed lives for digital switching from 8.6 to 9.2 years. Upon discontinuance of FAS 71, the major ILECs used lives for digital switching ranging from 7 to 12 years. Even under Commission regulation, AT&T's last prescribed life for digital switching was 9.7 years in 1994. Based on these comparables, it is obvious that a 13-18 year range is still far too high.

The lives in several other categories are in equal or greater need of review and revision based on similar considerations and forward-looking analysis. The NPRM does not appear receptive to a forward-looking analysis of the 33 other categories because the only reason cited for not proposing changes to other ranges is that historical retirement rates reported in ARMIS appear unchanged.[60] This clearly does not suggest a forward-looking approach.

Digital circuit is another category that is in dire need of updating. The Commission should adopt a range from 7 to 13 years for this category. This recommendation is based on SWBT's 1998 study, external financial reporting ranges, an AT&T 1994 prescribed life of 7.2

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[59] See Vanston, Hodges & Poitras, Transforming the Local Exchange Network: Analyses and Forecasts of Technology Change (2d ed. 1997).

[60] NPRM, ¶11. Statement of Dr. Robert G. Harris, Exhibit "A", at 13.

years and the short economic lives used by other competitors. For example, the lives used by Electric Lightwave and TCG are 8 and 10 years, respectively.[61] Again, the comparables show that an 11-13 year range is too high.

In addition, the Commission should review and revise all of the cable accounts, metallic and nonmetallic. Using the same type of forward-looking economic analysis described above, the SBC LECs submit that the ranges of the cable accounts need to be lowered significantly.

The following table shows that the current Commission ranges for the cable accounts are too high compared to SWBT's 1998 study, external financial reporting by major ILECs and the ranges prescribed for AT&T four years ago in 1994:[62]

Account	SWBT's 1998 Study Proposal of FAS 71	Major LEC Range Upon Discontinuance AT&T	1994 FCC Prescribed Lives for	FCC's Prescribed Ranges
Underground Cable – Metallic	12.5 – 15.5	12 – 19	9	25 - 30
Underground Cable – Nonmetallic	20	15 – 20	20	25 – 30
Buried Cable – Metallic	18 – 19	14 – 20	15	20 – 26
Buried Cable – Nonmetallic	20	15 – 20	20	25 – 30
Aerial Cable – Metallic	13.5 – 16	14 – 19	Not Applicable	20 – 26
Aerial Cable – Nonmetallic	20	15 – 20	20	25 – 30

The Commission should adopt lower ranges for the cable accounts that would permit the shorter lives proposed by the forward-looking analysis in SWBT's 1998 study.

Finally, if the Commission does not forbear completely, it should use a similar analysis in reviewing the ranges of other depreciation rate categories to bring them in line with a forward-

[61] See Statement of Dr. Robert G. Harris, Exhibit "A" at 15.

[62] Other competitors, such as TCG, also use the shorter lives for fiber optic cable.

looking approach.[63] Because of the rapid rate of change in technology, the competitive environment, and other factors, as discussed in Dr. Harris' attached paper, and the resulting difficulty in forecasting depreciation lives, it is impractical for the Commission to attempt to manage the depreciation process via protracted proceedings and long-overdue reviews. Therefore, the best solution would be for the Commission to remove itself completely from the depreciation process, at least with respect to price cap ILECs.

IV. AT A MINIMUM, PRICE CAP ILECS SHOULD BE GIVEN THE PRICE CAP CARRIER OPTION AS IT WAS ORIGINALLY PROPOSED IN 1992.

If the Commission does not remove itself from the prescription of depreciation rates of price cap ILECs, it should, at a minimum, permit them to use a price cap carrier option like the one proposed by the Commission in 1992 in CC Docket No. 92-296.[64] As originally proposed in the 1992 Depreciation NPRM, the price cap carrier option would only require an ILEC to file its existing and proposed depreciation rates and the resulting change in its depreciation expense.[65] While the ILEC's proposed depreciation rates would be placed on public notice for comment by state commissions and other interested parties, a price cap ILEC would not be required to furnish any supporting data for its proposed depreciation rates. Thus, this option would permit price cap ILECs to achieve significant administrative savings. Although depreciation prescription should no longer be deemed essential for any Commission purpose in regulating price cap ILECs, this alternative would permit the Commission to maintain some oversight of depreciation rates. The SBC LECs submit that the Commission should remove itself completely from the depreciation prescription process, but, if the Commission determines not to do so at this time, the price cap carrier option as originally proposed in 1992 is the second best alternative.

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[63] For example, computers should be 3-6 years instead of the Commission's 6-8 year range, poles should be 20-30 instead of 25-35, and conduit should be 30-40 instead of 50-60.

[64] 1992 Depreciation NPRM, ¶¶40-41.

[65] Id. ¶41.

Certainly, this alternative would provide more meaningful relief to price cap ILECs than the streamlining that the NPRM proposes for all ILECs. Given that, unlike the interstate rates of price cap ILECs, those of other ILECs are still subject to cost-based regulation, much greater streamlining is clearly justified for the price cap ILECs.

In suggesting that price cap ILECs may be allowed to set their own depreciation rates, the NPRM recognizes that price cap ILECs are entitled to more relief from the burden of depreciation regulation than other ILECs. Thus, if the Commission does not grant price cap ILECs full forbearance, it must give them more relief than the streamlining adopted for rate-of-return regulated ILECs. Therefore, if not granted full forbearance, price cap ILECs should at least be given the flexibility to set their depreciation rates without regard to any ranges adopted for rate-of-return ILECs, as well as the additional flexibility permitted by the original price cap carrier option.

For similar reasons, the NPRM's proposal to eliminate the theoretical reserve studies should apply to all ILECs, not merely to the mid-sized ILECs, as the NPRM proposes.[66] If price cap ILECs receive complete forbearance, then there is certainly no reason to require them to prepare these studies. But, even if the Commission does not grant them forbearance, eliminating

[66] NPRM, ¶17.

the studies for mid-sized ILECs while retaining the studies for price cap ILECs, would be irrational.[67]

V. GIVEN THAT REGULATION OF PRICE CAP ILECS' DEPRECIATION RATES IS UNNECESSARY, THE COMMISSION NEED NOT DETERMINE WHETHER "SUFFICIENT" COMPETITION EXISTS.

The Commission appears to be reluctant to eliminate depreciation regulation in the absence of sufficient competition. The Commission explains that, in competitive markets, "a carrier's ability to raise its depreciation rates would be constrained by its need to compete against other carriers, rather than by government regulatory constraints."[68] Thus, the Commission appears to believe that, absent sufficient competition, ILECs' depreciation rates still need to be subject to Commission regulatory constraints.

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[67] The NPRM states that "there is no apparent depreciation reserve imbalance." NPRM, n. 48. The SBC LECs disagree.

The Commission reaches this conclusion by comparing the book depreciation reserve to the theoretical depreciation reserve that is calculated using the Commission-prescribed rates. Instead, the true reserve deficiency should be determined by comparing the book reserve to a theoretical reserve that is calculated using forward-looking, economic depreciation rates. The result of these calculations in SWBT's case for 1997 are as follows (dollars in millions):

Book reserve	Backward-Looking Theoretical Reserve	Economic Theoretical Reserve
$14,359	$14,541	$18,346
DEFICIENCY:	$182 million	$3,987 million

Even using the Commission's prescribed rates, SWBT had a deficiency of $182 million in 1997. As shown by SWBT's 1997 economic deficiency of almost $4 billion, the level of imbalance is much higher if one uses economic depreciation rates because the Commission's theoretical reserve calculation is based on a process that is in dire need of reform. Thus, the SBC LECs certainly do not agree that the book reserve and the theoretical reserve are "approximately the same." NPRM, n.48. The above data illustrates the huge difference between the two figures, using truly forward-looking economic depreciation parameters. This type of analysis demonstrates the need for comprehensive reform of the depreciation process, the likes of which the Commission has not undertaken in almost twenty years – assuming the Commission does not forbear from regulating depreciation altogether.

[68] NPRM, ¶7.

However, by replicating a competitive environment, price cap regulation imposes a sufficient constraint on a price cap ILEC's pricing such that it is not reasonably necessary to regulate depreciation rates directly, especially now that sharing has been eliminated. Therefore, competition does not even need to come into play as a safeguard against higher service rates resulting from higher depreciation.

It is not necessary for the Commission to make any findings regarding the sufficiency of competition because price cap regulation provides adequate protection. Further, as discussed above, the impact of depreciation in other areas is either minimal or non-existent or it can be reviewed on a case-by-case basis if necessary for purposes of individual price cap ILECs.

In any event, the Commission underestimates the pace at which competition is increasing at the local level and the impact of this competition on ILECs' incentives. Dr. Robert Harris, in the paper attached as Exhibit A, shows that the NPRM's assumptions about the level of competition are flawed in several respects. Dr. Harris' attached paper and the SBC LECs' other recent filings in CC Docket No. 96-262 provide evidence that competition exists and that even more aggressive competition is imminent. While it is not necessary to find significant competition in order to eliminate depreciation regulation of price cap ILECs, the Commission should recognize that competitive forces are at work and accelerating. These accelerating competitive forces further reduce the need for depreciation prescription because they make it even less likely that an ILEC could recover increases in depreciation costs through higher rates.

In fact, as part of the public interest analysis of USTA's forbearance petition, the Commission is supposed to consider the impact that forbearance will have on competitive market conditions.[69] In this case, lifting the burden of a costly, complex regulatory process from the shoulders of one group of competitors would clearly be a pro-competitive move.

[69] 47 U.S.C. § 160(b). See also USTA Petition at 9, 16-18.

VI. THE COMMISSION SHOULD DEFER TO ANY GAAP ACCOUNTING PRINCIPLES THAT MAY BE ADOPTED TO GOVERN SALVAGE.

The NPRM proposes to eliminate future net salvage ("FNS") from the Commission's depreciation process and to require ILECs to treat salvage and cost of removal as a current expense as they are incurred.[70] In the alternative, the Commission suggests that it could give ILECs the option of treating FNS in this manner.

As a general matter, the Commission should remove itself from the process of prescribing price cap ILECs' depreciation rates, including the FNS component of the Commission's depreciation formula. To the extent the Commission continues prescribing depreciation rates, it should defer to any official accounting principles that are adopted as Generally Accepted Accounting Standards ("GAAP"). In February 1996, an Exposure Draft was released by the Financial Accounting Standards Board regarding "Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets."[71]

If and when this Exposure Draft or a revised version of it is adopted as an official accounting standard, the Commission should defer to this accounting standard and allow ILECs to comply with it, notwithstanding any Part 32 requirements to the contrary. In the interim, the Commission should permit price cap ILECs to recognize FNS over the life of an asset, without being subject to any prescribed factors or ranges.

It is not necessary to create a new account to record the net cost of removal, as proposed in the NPRM.[72] In the event that GAAP standards are adopted that permit or require some net cost of removal to be treated as a current expense, then ILECs should be permitted to book this

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[70] NPRM, ¶14.

[71] Financial Accounting Standards Board, Proposed Statement of Financial Accounting Standards No. 158-B, "Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets" (Financial Accounting Series February 7, 1996.)

[72] NPRM, ¶16.

expense in the existing Class B account, Account 6560. As the SBC LECs and others have argued in CC Docket No. 98-81, the Commission should allow all ILECs to use the Class B system of accounts,[73] which would eliminate the need to create a new account in the event any net cost of removal is treated as a current expense under applicable GAAP standards.

VII. CONCLUSION.

While the NPRM recognizes that greater relief from depreciation requirements is justified for price cap ILECs than rate-of-return ILECs, the number of obstacles raised in the NPRM indicate that the Commission may be reluctant to give up any control over the depreciation prescription process. However, as the SBC LECs have shown above, elimination of this hold-over from rate-of-return regulation would not "have an adverse impact in several critical areas."[74] In fact, depreciation regulation is no longer necessary for purposes of regulating the rates of price cap ILECs or protecting consumers and it is not in the public interest. Therefore, forbearance from applying such regulation to price cap ILECs is justified under the Section 10 standards, as explained in USTA's Petition. Eliminating unnecessary depreciation regulation is in the public interest because it will enhance competition by not subjecting one group of competitors to the heavy burden of depreciation studies, review process and filings. It will also permit price cap ILECs and the Commission to operate more efficiently.

Elimination of depreciation regulation of price cap ILECs is also justified under the Section 11 standard because such regulation is no longer necessary in the public interest, in light of the price cap regulatory model, and as a result of meaningful economic competition. The price cap regulatory model substantially eliminates the need to prescribe depreciation rates for purpose of any rate-of-return or cost-based regulation. The minimal benefits of continuing to prescribe depreciation rates are not justified by their burden, especially in view of the

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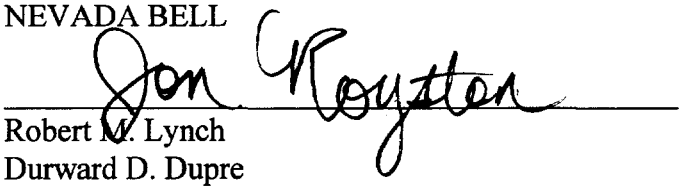
[73] See, e.g. Comments of SBC LECs, CC Docket No. 98-81, filed July 17, 1998, at 5-17, 20-24.

[74] NPRM, ¶19.

development of significant levels of competition for ILECs' regulated services. As the SBC LECs and others have demonstrated in recent filings[75] and as discussed in Dr. Harris' attached paper, there can be no dispute that competition has increased to a meaningful level since enactment of the 1996 Act. In the case of some segments of the market, competition has reached extreme levels. This actual competition and the increasing threat of even broader competition require the Commission to proceed with the elimination of hold-overs from rate-of-return regulation which price cap regulation was designed to render unnecessary and which are impeding competition.

Respectfully submitted,

SOUTHWESTERN BELL TELEPHONE COMPANY
PACIFIC BELL
NEVADA BELL



Robert M. Lynch
Durward D. Dupre
Roger Toppins
Darryl W. Howard
Jonathan W. Royston

One Bell Plaza, Room 3022
Dallas, Texas 75202
214-464-5534

Their Attorneys

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[75] See, e.g., SBC LECs' Reply Comments, CC Docket Nos. 96-262, 94-1, 97-250 & RM 9210, filed through ECFS, November 9, 1998, at 2-16 & Appendices B & C. USTA Reply Comments, CC Docket Nos. 96-262, 94-1, 97-250 & RM-9210, filed November 9, 1998, at 29-32, and Attachments A & B.

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SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL
CC DOCKET NO. 98-137

Summary*

The Commission should remove itself completely from the prescription of depreciation rates of price cap ILECs. Since the Commission eliminated sharing in 1997, there is no good reason to continue prescribing the depreciation rates of price cap ILECs. As the last significant link between interstate prices and costs, sharing stood as the last remaining obstacle to meaningful simplification of depreciation regulation. When the Commission last reviewed depreciation regulation in 1993, the Commission gave AT&T significant relief from the depreciation requirements primarily because, unlike the ILECs' price cap plan, AT&T's plan did not have a sharing mechanism. In view of the elimination of sharing and escalating competitive pressures, price cap ILECs cannot, as a practical matter, impose any increases in depreciation expense on their ratepayers.

At one point, the NPRM inquires whether price cap ILECs should be permitted to set their own depreciation rates if they waive the low-end adjustment, but then it describes seven other reasons for either continuing to regulate depreciation rates or imposing other conditions. The NPRM suggests that depreciation regulation is still significant for purposes of the not only the low-end adjustment, but also productivity factor calculations, exogenous cost adjustments, the Base Factor Portion calculation, above-cap filings, universal service cost models, interconnection rates and takings claims. SBC submits that none of these is a good reason to continue to require price cap ILECs to follow burdensome depreciation prescription procedures.

As BellSouth recommended, it is not necessary to regulate depreciation for purposes of the low-end adjustment because the Commission can review depreciation rates at the time of any such filings, which are, in any event, rarely made. Besides, SBC and the USTA have recommended eliminating the low-end adjustment. Likewise, in the event of the even more rarely

* The abbreviations used in this Summary are defined in the body of these Comments.

used above-cap filings, the Commission can review depreciation on a case-by-case basis at the time of any such filings.

The productivity factor calculations are no reason to regulate depreciation because when the entire X-factor is considered, a change in depreciation rates would not result in any change in the X-factor. An increase in depreciation rates causes two components of the X-factor to change in opposite directions by equal amounts, resulting in a net impact of zero.

Exogenous cost determinations are no reason to regulated depreciation because changes in depreciation rates are endogenous. Thus, it is unclear how a change in depreciation rates could affect an exogenous cost determination. Even if it did, the Commission could review depreciation rates at the time of the exogenous filing.

Because the Base Factor Portion ("BFP") calculation is going to become an entirely revenue-based calculation, changes in depreciation rates will not affect it.

Depreciation regulation is not necessary for purposes of universal service. It does not make sense to use the actual, backward-looking depreciation rates prescribed by the Commission based primarily on past mortality experience given that the Commission has chosen to use a forward-looking economic cost model that assumes a hypothetical ILEC network using the least-cost, most efficient technology available. It is very unlikely that these prescribed depreciation rates would have any rational relationship to the hypothetical investment and costs used in the Commission's model.

Interconnection and takings are also not good reasons to continue regulating depreciation. Interconnection and other local pricing should be left to the states. The states are even beginning to recognize that it is not necessary to prescribe depreciation rates. Eliminating depreciation regulation would actually mitigate the stranded cost problem because the Commission would no longer be responsible, on a going-forward basis, for any further under-recovery of investment attributable to uneconomic depreciation rates.

To the extent the Commission does not eliminate depreciation regulation completely for all ILECs, it should conduct a comprehensive review of its regulations and the life ranges. The

NPRM's proposed streamlining would provide virtually no relief from the burden of these regulations. The proposal to require only four summary exhibits is insignificant because ILECs would still have to perform all of the same studies to support those four summary exhibits. Also, the NPRM only proposes to expand the life range of one out of 34 plant categories. Instead of such a narrow focus, the Commission must seriously reconsider the ranges of all 34 categories using a truly forward-looking economic approach, instead of the Commission's long-standing practice of relying almost exclusively on past mortality and retirement data.

Competitive factors, an accelerating rate of technological change and other interrelated factors are shortening the lives of network equipment and are making it extremely difficult to estimate the forward-looking lives of that plant. It is not practical for a regulator to keep up with all of these developments and to accurately update its depreciation policy on a regular basis every year. However, if the Commission insists on retaining control of any ILECs' depreciation practices, it must keep up with developments with much greater regularity than in the past, it must develop a truly forward-looking approach and, as a first step, it must adjust all of its life ranges to reflect a new, forward-looking approach. The best solution would be for the Commission to remove itself completely from the depreciation process.

If the Commission does not grant price cap ILECs complete forbearance, it should at least give them the price cap carrier option, as it was originally described in 1992. Under this second best alternative, an ILEC would not be bound by any ranges and it would only need to file its existing and proposed depreciation rates and the resulting change in its depreciation expense. While it is not necessary for the Commission to find that "sufficient" competition exists, the Commission should recognize that accelerating competitive forces are at work and that these forces further reduce the need for depreciation prescription because they make it even less likely that an ILEC could recover increases in depreciation rates through higher rates.

Finally, in removing itself from the process of prescribing depreciation rates, the Commission should also cease prescribing salvage factors. To the extent it does not, it should defer to any GAAP standards adopted to govern net salvage. Otherwise, ILECs should be

permitted to recognize net salvage ratably over the life of the asset, to the extent permitted by GAAP. If GAAP ultimately requires any removal costs to be booked as a current expense, the Commission should not create a new account, as suggested in the NPRM; instead, ILECs should be permitted to book this expense in the existing Class B account, Account 6560.